Research Update:

Cheplapharm Upgraded To 'B+' On New Capital And Improved Credit Metrics; Off Watch; Outlook Stable

November 4, 2022

Rating Action Overview

- Cheplapharm AG, parent company of off-patent branded pharmaceutical company Cheplapharm Arzneimittel GmbH (Cheplapharm) has received a new €550 million subordinated mandatory convertible instrument from investment company Atlantic Park and Singapore sovereign wealth fund GIC. Funds will be down-streamed to Cheplapharm in the form of common equity. We include this instrument in our calculation of Cheplapharm's S&P Global Ratings-adjusted debt under our methodology.
- We understand that Cheplapharm could potentially contemplate an initial public offering (IPO) but we consider it unlikely to do so in the near future because of adverse market conditions.
- We forecast the group's operational performance to remain strong in the next 12-18 months thanks to the successful integration of recent and potential new acquisitions, supporting S&P Global Ratings-adjusted debt to leverage of 4.0x-5.0x.
- We therefore raised to 'B+' from 'B' our long-term issuer credit ratings on Cheplapharm, as well as our ratings on its outstanding senior notes and on its term loan B (TLB), reflecting our expectation of 60% recovery prospects. We removed the ratings from CreditWatch, where we placed them with positive implications on Jan. 17, 2022
- The stable outlook indicates that we anticipate the company's disciplined approach will enable it to successfully integrate recent and potential future acquisitions, supporting S&P Global Ratings-adjusted debt to EBITDA of 4.0x-5.0x and high free operating cash flows (FOCF) in the next 12-18 months.

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Rating Action Rationale

We think Cheplapharm will maintain a financial policy consistent with S&P Global Ratings-adjusted debt to EBITDA of 4.0x-5.0x in 2022 and 2023, in line with the 4.2x achieved in 2021 and including the new convertible instrument, which we view as debt under our methodology. This is because, although the instrument is outside of the restricted group, the ultimate lenders Atlantic Park and GIC do not have a controlling interest in Cheplapharm. That

said, the convertible instrument is subordinated to all other debt and Cheplapharm can decide to pay interest in kind. We assume Cheplapharm will allocate the proceeds of the new convertible instrument, alongside its FOCF, to acquire new medicines. This is because its product portfolio primarily comprises niche and legacy products that have lost patent protection and are exposed to price erosion and generic competition. As such, we forecast a natural decline in sales by 3%-5% per year and we note that Cheplapharm's business model focuses on sourcing assets from outside to offset this. We anticipate that the company will continue to apply its disciplined policy of paying low acquisition multiples of 3x annual sales or less on average, which will enable a return on investments within a maximum of six years on average. We do not anticipate any dividend payment in the next 12-18 months, in line with Cheplapharm's dividend policy.

Cheplapharm is integrating its recent acquisitions well, and we forecast its disciplined buying strategy will continue to support revenue growth in the next 12-18 months, despite some execution risks. In the first half of 2022, Cheplapharm acquired cytomegalovirus treatment Valcyte from Roche; three chemotherapeutical medicines from Bristol Myers Squibb; 10 established medicines from Sanofi; and oncology product Xeloda. The integration of new assets carries execution risks associated with the required timely transfer of marketing authorizations (MA), the seamless integration of products into Cheplapharm's network of contract manufacturing organization, and the realization of targeted gross margins from new products. The company has increased its staff to 492 as of June 2022, from 461 a year before, which should help it manage the transfer of MAs for the new products in each country. It has also achieved a high gross margin of 75%, as reported by the company, which suggests a successful integration so far. We note Cheplapharm's successful track record of transferring MAs and integrating acquired products into its network of manufacturing partners within the timeframe agreed with the seller. Moreover, Cheplapharm has historically been disciplined regarding the price it pays for new products. It has also been careful to acquire branded products that do not require marketing efforts to realize the expected gross profit. We expect Cheplapharm to continue applying its disciplined acquisition policy and therefore manage execution risks. This should support our forecast of revenue growth of 11%-13% in 2022 and 13%-15% in 2023, including potential new acquisitions in the second half of 2022 and in 2023.

We anticipate that Cheplapharm will continue to generate high annual FOCF of €380 million-€420 million in 2022, and €450 million-€500 million in 2023 thanks to its strong profitability and limited capital expenditure (capex) requirements. Cheplapharm operates with an asset-light business model focused on a buy-and-build strategy. The company primarily focuses on acquiring the right target and subsequently outsources manufacturing, distribution, and marketing activities when required. Additionally, it does not have in-house research and development costs. This results in strong profitability; we anticipate an S&P Global Ratings-adjusted EBITDA margin of about 53%-55% in 2022 and 2023, which is lower than the 57.7% in 2021 because of higher costs of energy and materials. Given the asset-light business model we include in our base-case a maximum of €10 million annual capex. We forecast about €60 million-€80 million of annual working capital requirements, reflecting the need for growing inventories to absorb recent acquisitions and support revenue growth.

Cheplapharm's business model, which relies solely on the acquisition of new medicines to deliver future growth, limits rating upside. This approach could lead to the company overspending on acquisitions and increasing leverage to close to 5.0x. The integration of acquisitions could also increase volatility in FOCF generation due to the need to rollout sales and marketing forces and integrate inventories, which could mean volatile working capital

requirements.

Outlook

The stable outlook reflects our forecast that Cheplapharm's operating performance will remain resilient and that it will achieve an S&P Global Ratings-adjusted EBITDA margin of 53%-55% and debt to leverage of 4.0x-5.0x in 2022 and 2023, reflecting its disciplined acquisition policy and the seamless integration of recent acquisitions. Our forecast considers the risk that the debt leverage ratio could temporarily deviate from this level, depending on the timing of acquisitions. We also forecast Cheplapharm to generate high annual FOCF, such that FOCF to debt will remain 10%-15% over the next 12-18 months.

Downside scenario

We could lower the rating if Cheplapharm's debt to leverage deteriorates beyond our base case without prospects of deleveraging within the 12-18 months after the latest debt-financed acquisition, or if its ability to generate high FOCF deteriorates. This would most likely occur if Cheplapharm acquired a portfolio of medicines at high EBITDA multiples, or faced unexpected setbacks in integrating new assets, leading to greater costs and working capital requirements than planned. Under this scenario, we would also likely see Cheplapharm's ability to cover cash-interest payments deteriorate.

- Our downside scenario comprises the following triggers:
- Adjusted debt to EBITDA of 5.0x or above.
- FOCF to debt declining to below 10%.
- FFO cash interest coverage declining to below 4.0x.

Upside scenario

We could consider an upgrade if Cheplapharm's debt to leverage improves sustainably and it continues to generate high FOCF. To consider raising the rating, we would need to see Cheplapharm applying a financial policy consistent with lower leverage. This would most likely happen if, for example, the company continued to apply a disciplined acquisition strategy while remaining free of integration setbacks and if it relied only on self-generated cash flows, rather than new debt, to fund product acquisitions.

Our upside scenario comprises the following triggers:

- Adjusted debt-to-EBITDA ratio sustainably at or below 4.0x, combined with a financial policy that includes sufficient capital headroom to fund the necessary acquisitions; and
- FOCF to debt ratio comfortably in the 15%-25% range.

Company Description

Cheplapharm is a Germany-headquartered off-patent branded pharmaceutical company. It reported revenue of €1.08 billion and S&P Global Ratings-adjusted EBITDA of €624 million in 2021. Cheplapharm generates most of its revenues from Europe (69% of 2021 sales), followed by Asia

(13%) and North America (6%). It generated the remaining 12% of sales from the rest of the world.

The company mainly acquires intellectual property rights from pharmaceutical companies after the respective products have run out of patent protection, but while they still demonstrate relatively stable revenue. Cheplapharm operates with an asset-light business model focused on a buy-and-build strategy. Primarily, the company identifies the right target, outsources manufacturing, distribution, and marketing by utilizing contract manufacturing organization and external networks; and implements its experienced life-cycle management activities to optimize the process.

Cheplapharm is fully owned by Sebastian Braun, the company's co-CEO, and Bianca Juha, Chief Scientific Officer, through the family holding Braun Beteiligungs GmbH.

Our Base-Case Scenario

Assumptions

- Revenue growth of 11%-13% in 2022 and 13%-15% in 2023, stemming from the integration of recent acquisitions and considering potential future acquisitions. We incorporate about 3%-5% annual revenue decline on Cheplapharm's portfolio of niche and legacy medicines.
- Adjusted EBITDA margin of 53%-55% in 2022 and 2023 thanks to Cheplapharm's asset light business model and focus on life-cycle management.
- Working capital requirement of about €60 million-€80 million annually in 2022 and 2023, reflecting the integration of inventories for acquired products.
- Limited annual capex requirement of up to €10 million.
- €600 million-€800 million annually for product acquisitions.

Key metrics

- Adjusted debt to EBITDA of about 4.7x-4.9x in 2022 and 4.4x-4.6x in 2023.
- FFO cash interest coverage ratio of about 5.0x-6.0x in 2022 and 2023.
- FOCF to debt ratio of 10%-15% in 2022 and 2023

In our debt calculation, we include a €1,480 million TLB, €1,075 million senior secured notes, $500 million senior secured notes, any amount drawn under the €545 million RCF, €30 million of shareholder loan, €550 million of mandatory convertible instrument, and €102 million of available cash and liquid securities as of December 2021.

Liquidity

We view Cheplapharm's liquidity as adequate, indicating that sources of cash will cover uses by at least 1.2x over the next 12 months. Even if EBITDA were to decline by 15%-20%, we forecast that net sources of liquidity would remain positive. We assess liquidity on an ongoing basis and therefore do not include the one-off effects of debt-funded transactions.

We anticipate that Cheplapharm's liquidity sources over the 12 months from June 30, 2022, will

be:

- €345 million of cash and equivalents;
- €148 million available under the €545 million RCF; and
- €500 million-€550 million forecasted cash FFO.

We forecast the following liquidity uses for the same period:

- €60 million-€80 million of working capital;
- €80 million of maximum intra-year working capital swing; and
- Up to €10 million of annual capex.

Covenants

The senior facility agreement includes a springing covenant tested quarterly when 40% or more of the RCF is drawn. Under this covenant, the net senior secured leverage ratio is limited to 6.0x.

In our base case, we forecast Cheplapharm to maintain adequate headroom of at least 15% under its financial covenant, should it be tested.

Issue Ratings - Recovery Analysis

Key analytical factors

- The senior secured €1.48 billion TLB due 2029, the €500 million senior secured notes due 2027, the €575 million senior secured notes due 2028, and the $500 million senior secured notes due 2028 have an issue rating of 'B+' and recovery rating of '3'.
- This indicates our expectation of meaningful recovery prospects in the 50%-70% range (rounded estimate: 60%)
- In our hypothetical default scenario, we assume a lack of target products available at accessible prices and an increase in price pressure.
- We value Cheplapharm as a going concern, given its well-established branded generics position and its well-diversified portfolio in geographical terms.

Simulated default assumptions

- Year of default: 2026
- Jurisdiction: Germany

Simplified waterfall

- Emergence EBITDA: €365 million
- Capex represents 0.5% of sales

- 35% operational adjustment to reflect low capex requirement, high profitability, and free cash flow conversion
- Multiple: 6.5x
- Gross recovery value: €2.37 billion
- Estimated net recovery value after administrative expenses (5%): €2.25 billion
- Estimated senior secured claims: €3.56 billion[1]
- Recovery range: 50%-70% (rounded estimate: 60%)
- Recovery rating: 3

[1]All debt amounts include six months of accrued interest that we assume will be owed at default. We assume 85% drawdown under the RCF at default.

Ratings Score Snapshot

Issuer Credit Rating: B+/Stable/--

Business risk: Fair

- Country risk: Intermediate
- Industry risk: Low
- Competitive position: Fair

Financial risk: Aggressive

- Cash flow/leverage: Aggressive

Anchor: bb-

Modifiers:

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

ESG credit indicators: E-2, S-2, G-2

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities, April 29, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Pharmaceutical Industry, April 8, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings List

Upgraded; CreditWatch/Outlook Action

	To	From
Cheplapharm Arzneimittel GmbH		
Issuer Credit Rating	B+/Stable/--	B/Watch Pos/--
Senior Secured	B+	B/Watch Pos
Recovery Rating	3(60%)	3(50%)

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914